Interaction and potential problems

Kevin Offer considers the interaction between capital gains tax and inheritance tax along with some of the opportunities and pitfalls.

The rules on capital gains tax and inheritance tax can be tricky at the best of times. There are, however, many instances when they interact, creating additional problems and some opportunities for effective planning. Interestingly, the Office for Tax Simplification looks at the interaction of these taxes in some depth (tinyurl.com/otsihtjul19).

Sale of assets

When an asset is sold most practitioners will consider the capital gains tax position but may ignore the effect on the potential inheritance tax charge on the vendor's estate. For example, a gain on the sale of a business asset by an individual will give rise to a capital gains tax liability. If the vendor were to die within seven years, any cash proceeds or assets acquired by the vendor not qualifying for business property relief remaining in their estate would become liable to inheritance tax. So it may have been better to retain the business asset until death when no capital gains tax or inheritance tax may have arisen rather than suffer the combination of capital gains tax on the sale and inheritance tax on death.

Lifetime gifts

The situation becomes further complicated with a gift rather than a sale. Capital gains tax is payable on a disposal by way of gift based on the market value of the asset at the time of disposal. That tax will need to be paid from other funds and, depending on personal circumstances, a charge at 20% or 28% may not be desirable.

Key points

- Capital gains tax and inheritance tax can be due on one transaction.
- Reliefs should be carefully reviewed.
- Availability of business property relief can change between gift and death.
- Transfers into trust usually benefit from holdover relief.
- Timing of distributions can be critical.

For inheritance tax the gift will be a potentially exempt transfer (PET), so no inheritance tax is due at that time. However, if the transferor were to die within seven years of making the gift, the value of the asset at the time of the gift will be chargeable to tax at up to 40% depending on how many years the transferor survives the making of the gift. The capital gains tax paid at the time of the gift will not be allowed as a deduction against the inheritance tax charge and so both taxes would become payable.

One advantage of a lifetime gift is that inheritance tax may be avoided on any increase in value from the time of the gift up to the date of death. The increase would be chargeable to capital gains tax on a subsequent sale but that would be at a lower rate than inheritance tax. It is, therefore, generally good planning to make gifts during lifetime, even when death may be within seven years.

When the lifetime gift is of a business asset, two separate reliefs may be available. For capital gains tax, a claim for holdover relief under TCGA 1992, s 165 may be possible. Such a claim would defer all or part of the capital gains tax due at the time of the gift until a sale of the asset by the transferee. It is necessary, however, to consider whether a claim for entrepreneurs' relief, if available, is a better option. A charge to capital gains tax at 10% now may be preferable to a charge to capital gains tax at 20% in the future.

For inheritance tax, the gift would be regarded as a PET but this may be of no immediate concern if it is believed that a claim for business property relief would be available. If the transferor were to die within seven years, the value of the gift would become chargeable to inheritance tax but business property relief would apply. However, if the transferee has sold the asset after the gift is received, business property relief will not be available. It may therefore be better to retain the assets until death.

These alternatives are considered in ***Gift to daughter***.

Gifts to trusts

There are several instances when assets held in a trust can give rise to both capital gains tax and inheritance tax charges.

A transfer of assets to a trust is one of the few situations when a chargeable lifetime transfer (CLT) will arise for inheritance tax. So, if an asset is transferred to a trust, there will be a charge to inheritance tax on the value of the asset – less the nil rate band if not used previously. The rate of inheritance tax is 20%, being half the lifetime rate. If the settlor dies within seven years of the gift, the transfer will be liable at the rates applicable on death with a credit for the tax paid on the CLT.

For capital gains tax, the transfer would be a disposal by the settlor. Holdover relief under TCGA 1992, s 260 applies, however, when a gift is chargeable to inheritance tax – or would be but for an exemption. So, if a parent wishes to make a transfer of an investment property to a discretionary trust, there would be no capital gains tax and the trust would take on the base cost from the settlor.

Similarly, if the property was transferred out to a beneficiary in the future, a claim to holdover relief under s 260 by the trustees may be possible. The relief is also available when no inheritance tax is payable such as if the value of the asset falls within the nil rate band or where business property relief is available.

This relief may lead one to believe that capital gains tax is not an issue on transfers in and out of trusts. There are, however, some instances where this charge can arise.

Consideration

Not all asset transfers are gifts. If a property is sold to a discretionary trust at an undervalue there will be consideration received by the transferor. To the extent that the consideration exceeds the cost of the property that proportion of the gain may not be held over.

Settlor-interested trusts

Holdover relief under s 260 is not available if the settlor retains an interest in the trust. The settlor will have an interest in the trust if he, his spouse or civil partner or dependent children are capable of benefiting from the trust assets.

In addition, a settlor-interested trust will also give rise to a gift with reservation of benefit for inheritance tax purposes. The settlor may therefore find that the assets within the trust remain in his estate.

Clawback of relief

There are some events which may cause holdover relief under s 260 to be withdrawn up to six years after the tax year of disposal.

This anti-avoidance rule is widely drafted but generally applies if the trust becomes settlor-interested at a later date or whereby arrangements take place that can result in the trust becoming settlor-interested at some point in the future.

Gift to daughter

Adam wishes to make a gift of shares to his daughter, Clare, which she will then sell to acquire a property. The shares are in an unquoted trading company and would qualify for business property relief and holdover relief. The cost of the shares is £20,000 and they have a current value of £100,000. Clare sells the shares for £120,000.

Capital gains tax

If Adam transfers the shares to Clare a claim for holdover relief would be available so no capital gains tax would be payable at that time.

When Clare sells the shares, she will be subject to capital gains tax on a gain of £120,000 – £20,000 = £100,000. This would give rise to a maximum capital gains tax charge of £20,000.

If, however, Adam met the conditions for entrepreneurs' relief in respect of the shareholding, a claim to holdover relief would not be advisable. There would then be a charge to capital gains tax on the transfer to Clare of £100,000 – £20,000 = £80,000.

This would give rise to a maximum capital gains tax charge of £8,000.

When Clare sells the shares, she will be subject to capital gains tax on the gain of £120,000 – £100,000 = £20,000.

This would give rise to a maximum capital gains tax charge of £4,000.

The total capital gains tax if entrepreneurs' relief is available would then be £12,000.

Inheritance tax

A gift during Adam's lifetime is a PET so would only become subject to inheritance tax if he were to die within seven years.

If Clare has not sold the shares at the time of death, business property relief would prevent a charge to inheritance tax.

If she has sold the shares, business property relief is not available. The value at the time of the gift of £100,000 would be chargeable to inheritance tax of up to £66,667 – if the gift is made free of tax.

It may therefore have been preferable for Adam to consider transferring other assets or consider making the gift through his will.

Gift through will

If the gift were to be made through Adam's will on death there would be no capital gains tax charge.

As business property relief is available there would be no inheritance tax on death.

Clare would then inherit the shares free of tax and with a base cost equivalent to market value on death.

Timing of distributions

As mentioned above, the relief is available when an inheritance tax charge arises. If a transfer does not fall within that charge, relief under s 260 will not be available.

Distributions within two years of the creation of a discretionary trust set up by will on death will not generally give rise to an inheritance tax charge so relief is not available under s 260.

A distribution from a trust within three months of a settlement being created or within three months of a ten-year anniversary charge will not give rise to an inheritance tax

Trust

A trust contains an asset with:

- a value of £300,000; and
- a base cost of £200,000.

On a ten-year anniversary of the creation of the trust no inheritance tax is due because the value of the asset is covered by the nil rate band of £325,000 and the trustees decide at that time to distribute the asset to the beneficiary.

If the asset is distributed within three months of the ten-year anniversary - no inheritance tax is due.

The trustees are treated as realising a gain at the time of making the distribution of:

£300,000 – £200,000 = £100,000.

This will be subject to capital gains tax of up to £20,000.

If the trustees were to delay the distribution until four months after the ten-year anniversary it will fall within the charge to inheritance tax.

Holdover relief is therefore available and no capital gains tax will be payable. In addition, as the inheritance tax charge on the distribution will be based on the rate that applied for the ten year anniversary, no inheritance tax should be due either.

Timing a distribution just before a ten-year anniversary of an asset with a current value exceeding the nil rate band should also be considered by trustees if no inheritance tax was due at the time of the previous ten-year anniversary. If a distribution is delayed until after the ten-year anniversary an inheritance tax charge would arise.

charge so, again, no holdover relief will be available under s 260. This can lead to unexpected charges as shown in ***Trust***.

Care with reliefs

This article highlights some of the problems arising from the interaction of capital gains tax and inheritance tax but it should be borne in mind that, generally, the UK tax system operates to avoid double charges to tax. Care should be taken, however, when considering assets that qualify for business property relief and other reliefs, especially if it is known that the transferee intends to dispose of the assets gifted. For capital gains tax, it is not always advantageous to claim reliefs on gifts such as holdover relief so a full review of the position should be undertaken as part of any tax planning exercise.

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